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Cancellation of Installment Obligations

Neil E. Harl
Iowa State University, harl@iastate.edu

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DEFERRED PAYMENT CONTRACTS

by Neil E. Harl*

For farmers who have had a good income year, autumn brings more than harvest; it is often accompanied by efforts to defer income from crops and livestock until the next taxable year. In the face of the constructive receipt doctrine,[1] the question is whether agreements to defer income will be successful.

Actually, there are two different techniques or approaches to use in income deferral. The choice depends upon the facts of the particular case. Each of the possibilities comes with a unique collection of pluses and minues.

Installment reporting. Since the Installment Sales Revision Act of 1980[2] became effective, farmers on the cash method of accounting have been eligible to defer income using conventional installment reporting rules.[3] That has been the case even though inventory property generally is not eligible for installment reporting.[4]

Under the 1980 amendment, an installment sale does not include "a disposition of personal property of a kind which is required to be included in the inventory of the taxpayer if on hand at the close of the taxable year."[5] A farmer on the cash method of accounting is not required to include grain and livestock in inventory.

The 1980 amendment was enacted because of problems that had arisen in using the approach then in common usage.[6] Both crops and livestock are eligible to use the installment reporting rules.

The installment reporting option has a firm statutory base and is relatively free of IRS challenges. Installment sale treat-ment applies automatically to eligible transactions unless the taxpayer elects otherwise.[7]

There are, however, two problems with installment reporting of farm inven-tory.

• The first problem, which at the moment poses only a *potential* problem, is that the Tax Reform Act of 1986 contained a provision specifying that installment sale treatment could be denied for "property of a kind regularly traded on an established market" *but only under regulations to be issued*.[8] Such regulations have not been issued. Considering, however, that sales of corn, wheat, cotton, soybeans, cattle, hogs, sheep or other farm inventory are ". . . regularly traded on an established market . . .," the potential threat to installment reporting of farm inventory exists.

The legislative history of the provision casts no light on the question of whether the Congress intended to impact grain and livestock sales.

• The other problem with installment reporting of farm inventory is not merely a potential problem; it is very real, at least for those vulnerable to alternative minimum tax. That is because installment reporting of inventory property is targeted by the alternative minimum tax rules.[9]

The legislative trail began with the Tax Reform Act of 1986. Under that legislation, amounts recognized from sales of inventory property or property held for sale to customers in the ordinary course of business under installment sale obligations were included in alternative minimum taxable income in the year of disposition.[10] The breadth of that provision generated considerable controversy. Under the Revenue Act of 1987, for dispositions after March 1, 1987, the provision was amended to include "property described in section 1221(1)" (basically inventory property and property held for sale to customers in the ordinary course of business).[11] The language of the 1987 amendment encompassed sales of grain and livestock inventory. Thus, such sales are to be reported *without regard to the installment method of reporting*.[12]

The bottom line is that taxpayers who are already liable for alternative minimum tax—and those who would be subject to AMT if the amount of installment reporting exceeds the $40,000 exemption[13]—should consider whether installment reporting of inventory property is a good idea.

Pre-1980 rules. Dating back to the late 1940's, farmers have been endeavoring to defer income from sales of the commodity one year with payment the next.[14] A few cases were unsuccessful, notably those seeking to defer income for more than a year or two.[15] The practice received a significant boost in 1958 with publication of *Rev. Rul. 58-162*.[16] In that ruling, the Internal Revenue Service agreed that a binding contract for the sale of grain with payment to be made in the following year would effectively defer income until the year of actual receipt.

IRS had, however, consistently refused to permit the deferred reporting of income from livestock sales where the purchaser was considered to be an agent of the seller.[17] Such a deferred payment sale was

* Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; Member of the Iowa Bar.

viewed by IRS as ineligible for deferral of income tax liability. A U.S. District Court, however, disagreed and held that a farmer on the cash method of accounting selling livestock where the purchaser was not technically an agent of the seller should be taxed in the year payment was received.[18] In that case, the year of receipt of payment was the year following delivery of livestock to a market corporation that sold the livestock through an auction market. Presumably, the IRS resistance to deferral of income tax liaibility from livestock sales using deferred payment contracts where the purchaser is an agent of the seller continues although no pronoucement has been made since the late 1970's.

The great drawback to deferral of income tax liability by binding contract came from a 1979 private letter ruling. In *Ltr. Rul. 8001001*,[19] the IRS took the position that if the contract right that farm taxpayers received for their property could be assigned or transferred at fair market value, that value must be taken into income in the year of sale.[20] In that ruling, a farmer on the cash method of accounting entered into a sales contract for grain delivered to the buyer in the year of the transaction but for which payment was deferred for two years. The contractual right to payment was deemed to have a fair market value with income recognized in the year of sale.

Following publication of *Ltr. Rul. 8001001*,[21] which was viewed by practitioners as a shocking development, two responses were observed—(1) efforts were commenced to amend the then-pending Installment Sales Revision Act, which efforts were ultimately successful as noted above, and (2) deferred payment contracts were deliberately made nonassignable and nontransferable.

Presumably, such nonassignable, nontransferable contracts have continued to be successful in deferring income. Moreover, inasmuch as such deferral arrangements are not installment sales and do not rest on I.R.C. § 453 for authority, it is believed that such contracts are not subject to alternative minimum tax as are installment sales.

A 1987 private letter ruling has sounded a warning about the use of some types of deferral arrangements operating outside of the installment reporting rules.[22] In that ruling, a farm landlord executed a "price later" contract with title to the grain passing to the buyer and with the seller given the right to set the price on any day within the next 365 days (which the seller failed to do). The seller received a premium for entering into the contract (because of the unusual crop basis existing at that time) which was duly reported into income in that year. The ruling holds that the crop share rent income was recognizable in the year the grain was sold to the elevator. IRS viewed the transaction as a sale at a "reasonable price." One of the surprising features of the ruling was that IRS analyzed the matter under rules of the Uniform Commercial Code (UCC) and ignored the cases and rulings that had emerged over the 40 years prior.

It is not clear whether the result in the 1987 ruling was because the ruling submission ignored the earlier cases and rulings, whether the "price later" feature was fatal, whether the premium paid to the seller in the year the transaction was entered into was material, whether the fact the seller was a landlord was significant or whether it was a combination of factors. Certainly it has been established for years that a landlord is constrained to a greater degree than farm operators in transferring crops without recognition of gain.[23] Perhaps the message of that ruling is that any significant deviation from a straightforward income deferral contract should be approached with great care by all farm taxpayers, but particularly by landlords. In particular, it is important for any price later contract to avoid application of the constructive receipt doctrine by providing specifically for deferral to the following year if the price is set in the year of the transaction.

Nontax considerations. Even though deferral of income tax liability should be possible under either approach, there are significant nontax considerations urging caution under both.

• If a commodity is delivered with title passing to the buyer, the seller is generally no more than an unsecured creditor of the seller. Thus, failure or bankruptcy of the buyer could (and has) resulted in major losses to sellers. Certainly, anyone entering into a deferred payment arrangement or installment sale with title and possession passing to the buyer should check carefully the financial standing of the buyer. Unfortunately, such a check is not always sufficient inasmuch as losses from commodity speculation, for example, can operate very swiftly to cut the equity base under a purchaser of commodities.

• For sellers of livestock, a deferred payment arrangment may act as waiver of the right to prompt next day payment assured under the Packers and Stockyards Act.[24] That protection is available for sales to purchasers acquiring more than $500,000 of livestock per year.[25]

Clearly, there are worse things than paying income tax—such as not collecting at all for the grain or livestock.

In conclusion. Farm taxpayers have a choice of two provisions with deferral of gain to the following year. Taxpayers wishing to defer income should examine carefully the potential AMT liability and, if the pre-1980 deferred payment contract is utilized, should use a carefully drawn contract that is binding on the parties and is nonassignable and nontransferable. It is also advisable for deferred payment contracts—(1) not to be modified after execution if possible; (2) for the account not to be debited at year end to pay for fertilizer, seed, feed, or other inputs remaining unpaid from the same merchant; (3) for payment not to be accelerated from the stated payment date, even by a day or two; and (4) for the instrument used to be a binding contract, not a promissory note (as has been observed in some cases when the supply of printed contracts became exhausted). Payment of interest on deferred payment contracts tends to make such contracts even less different from installment sales and should generally be avoided if characterization as installment sale would be disadvantageous.

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Footnotes

[1] Treas. Reg. § 1.451-2(a). See Ann. 87-3 I.R.B. 1987-2 (warning about applicability of constructive receipt doctrine to agreements to defer income from 1986 to 1987).

[2] Pub. L. 96-471, Sec. 2, 94 Stat. 2247 (1980).

[3] I.R.C. § 453(b)(2)(B).

[4] *Id.*

[5] *Id.*

[6] See 4 Harl, Agricultural Law § 25.03[2] (Matthew Bender 1989).

[7] I.R.C. § 453(d).

[8] I.R.C. § 453(j)(2), added by Pub. L. 99-514, Sec. 812(a), 100 Stat. 2371 (1986).

[9] See I.R.C. § 56(a)(6). See Letter from Glenn F. Mackles, Assistant Chief Counsel, Technical, Internal Revenue Service, to Rep. Pat Roberts, May 23, 1989.

[10] I.R.C. § 56(a)(6), added by Pub. L. 99-514, Sec. 701(a), 100 Stat. 2320 (1986).

[11] Revenue Act of 1987, Pub. L. 100-203, Sec. 10202(d), 101 Stat. 1330-358 (1987), amending I.R.C. § 56(a)(6).

[12] *Id.*

[13] See I.R.C. § 55(d).

[14] *E.g.*, J.B. Amend, 13 T.C. 178 (1949), *acq.*, 1950-1 C.B. 1, *app. dism'd*, (5th Cir. 4/8/50); Wilfred Weathers, 12 T.C. M. 314 (1953) (oral modification before harvest of prior written contract did not preclude deferral of income tax liability).

[15] See Hineman v. Broderick, 99 F. Supp. 582 (D. Kan. 1951) (unsuccessful attempt to defer sale of wheat for seven years; no continuous practice by taxpayer in deferring sales).

[16] 1958-1 C.B. 234.

[17] *E.g.*, Rev. Rul. 79-379, 1979-2 C.B. 204.

[18] Levno v. United States, 440 F. Supp. 8 (D. Mont. 1977).

[19] September 4, 1979.

[20] See Warren Jones Co. v. Commissioner, 524 F.2d 788 (9th Cir. 1975), *rev'g and rem'g*, 60 T.C. 663, *nonacq.*, 1980-1 C.B. 2.

[21] See note 19 *supra*.

[22] See Ltr. Rul. 8726007, March 23, 1987.

[23] See 7 Harl, *supra* Note 6, § 53.07[2], n. 16.

[24] 7 U.S.C. § 196. See discussion and cases cited in 10 Harl, Agricultural Law § 71.09[2][c] (Matthew Bender 1989).

[25] 7 U.S.C. § 196.

ANIMAL OWNER'S LIABILITY

HORSE OWNERS. Summary judgment for horse owner reversed where sufficient evidence was present for jury to find owner had breached duty of reasonable care to protect the injured rider from unreasonable risk of harm. Summary judgment for owner of horse stable where sufficient evidence present for jury to find stable owner breached duty to injured rider to exercise reasonable care to discover conditions which posed unreasonable risks to horse riders. Plaintiff, an inexperienced rider, injured head on overhang when highly trained show horse bolted through open gate in riding arena. **Dolezal v. Carbrey, 778 P.2d 1261 (Ariz. App. 1989).**

ANIMAL PROTECTION AND QUARANTINE

CATTLE AND BISON. The Animal and Plant Health Inspection Service (APHIS) has affirmed its interim rule changing the designation of Florida to an accredited-free state. **54 Fed. Reg. 42945 (October 19, 1989).**

SWINE. APHIS has announced proposed rules governing the identification of swine transported in interstate commerce. The swine must be identified at the the first of the following locations at which the swine arrive-- (1) where first commingled in interstate commerce with other swine, (2) where unloaded in interstate commerce at a livestock market, (3) where ownership is transferred in interstate commerce and (4) the final destination in interstate commerce. **54 Fed. Reg. 43065 (October 20, 1989).**

BANKRUPTCY

GENERAL

ABANDONMENT. Chapter 7 trustee was not allowed to vacate abandonment of real property where trustee failed to show bad faith. After the property was abandoned, the creditor received the full amount of its claim secured by the abandoned property after the debtor obtained another loan from a third party. ***In re* Gracyk, 103 B.R. 865 (Bankr. N.D. Ohio 1989).**

AUTOMATIC STAY. Corporation held not to be "individual" eligible to seek actual and punitive damages for IRS wilfull violation of automatic stay. The court declined to follow Budget Service Co. v. Better Homes of Virginia, 804 F.2d 289 (4th Cir. 1986) and *In re* Randy Homes Corp. 84 B.R. 799 (Bankr. M.D. Fla. 1988) which held that corporations may be considered "individuals" for this purpose. ***In re* Blue Water Bay, Inc., 89-2 U.S.T.C. ¶ 9566 (Bankr. M.D. Fla. 1989).**

IRS was held liable for actual and punitive damages for the wilfull violation of the automatic stay in the seizure of the debtor's personal assets used in the debtor's business where the debtor had informed the IRS of the pending personal and corporate bankruptcy cases and, although the corporation bankruptcy case had been dismissed, the debtor had claimed personal ownership of business assets seized by IRS. Although debtor did not provide IRS with conclusive evidence of personal ownership of business assets, the court held that the IRS had been given sufficient notice of possible ownership to require IRS to end the seizure until further investigation disclosed whether the assets were governed by the automatic stay in the debtor's bankruptcy case. ***In re* Lile, 103 B.R. 830 (Bankr. S.D. Tex. 1989).**